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**RE: TENNESSEE CONSUMER ADVOCATE DIVISION – REQUEST FOR
RULEMAKING AFFECTING RULES FOR ELECTRIC COMPANIES
(PROPOSED RULES FOR COST ALLOCATIONS AND AFFILIATE
TRANSACTION; AND REVISIONS TO REFLECT NAME CHANGE OF
THE TENNESSEE REGULATORY AUTHORITY, ETC.)
DOCKET NO. 98-00690**

Dear Mr. Waddell:

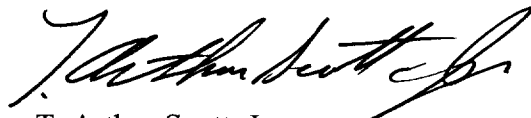
Enclosed please find the original and thirteen copies of **KINGSPORT POWER COMPANY'S REPLY COMMENTS TO THE COMMENTS OF THE CONSUMER ADVOCATE DIVISION AND THE INITIAL COMMENTS OF THE EDISON ELECTRIC INSTITUTE** which I would appreciate your filing.

Should you have any questions or comments regarding same, please do not hesitate to contact me directly.

With kindest personal regards, we are

Very sincerely yours,

HUNTER, SMITH & DAVIS, LLP


T. Arthur Scott, Jr.

Mr. David Waddell

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BEFORE THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

'99 JUN 14 AM 11 53

IN RE: TENNESSEE CONSUMER
ADVOCATE DIVISION – REQUEST FOR
RULEMAKING AFFECTING RULES FOR
ELECTRIC COMPANIES (PROPOSED
RULES FOR COST ALLOCATIONS AND
AFFILIATE TRANSACTION; AND
REVISIONS TO REFLECT NAME
CHANGE OF THE TENNESSEE
REGULATORY AUTHORITY, ETC.)

)
) OFFICE OF THE
) EXECUTIVE SECRETARY

) DOCKET NO. 98-00690

**REPLY COMMENTS TO COMMENTS OF CONSUMER ADVOCATE
DIVISION AND INITIAL COMMENTS OF EDISON ELECTRIC INSTITUTE**

Comes Kingsport Power Company, d/b/a American Electric Power, and for reply
comment on the Consumer Advocate Division's Comments on the Proposed Rules for
Cost Allocation and Affiliate Transactions and the Initial Comments of the Edison
Electric Institute submits the following:

**I. JURISDICTION OF TRA AND APPLICABILITY OF PROPOSED RULES
TO NONREGULATED AFFILIATES.**

Make no mistake about it, while the CAD's comments on applicability to
nonregulated affiliates seem to confirm that the proposed rules apply to no one at this
time, Kingsport Power and the AEP system would be greatly impacted by them if
certain federal statutes were changed.

While the CAD's comments correctly note the local nature of the TRA's authority
over public utilities, the CAD's synopsis of the proposed rules evades the impact of the
portions of the proposed rules dealing with Audit Requirements of affiliates.¹ The
CAD's comments state "[T]he proposed rules are not intended to and do not bring

¹ 1 COMMENTS OF CONSUMER ADVOCATE DIVISION at page 5.

nonregulated affiliates under the jurisdiction of the Authority. The rules simply identify the documentation required, and establish the criteria for determining how costs related to transactions between an electric utility's regulated and its nonregulated operations are to be recorded on the books of the utility and treated in evaluating and setting utility rates.”² In fact, the proposed rule provides that the Authority shall have “complete access” to all affiliate records and mandates that an audit trail exist as to the nonregulated affiliates. To the extent that any proposed rule alters or mandates conduct on the part of nonregulated affiliates, it practically brings the nonregulated affiliate under the auspices of the TRA's jurisdiction. The jurisdictional statute cited by the CAD does not specifically grant the TRA the authority to enact guidelines or rules affecting affiliates of Kingsport Power.

Additionally, the proposed rule attempts to enlarge the jurisdiction of the TRA to apply to all affiliates by mandating audit procedures which may effect the current methodologies of entities throughout the AEP system. As stated in Kingsport Power's Revised Comments, the TRA's predecessor declined to review methodologies within the AEP system regarding cost allocation. Rather, the Tennessee Public Service Commission found it adequate to confirm the existence of and compliance with those methodologies. Furthermore, the CAD correctly notes that all entities under the regulation of the Federal Energy Regulatory Commission (“FERC”) and the Securities and Exchange Commission (“SEC”) are exempt from the application of the proposed affiliate transaction rules. Kingsport Power and its affiliates, being part of a registered holding company, are entities subject to regulation by such agencies.

² PROPOSED COST ALLOCATION AND AFFILIATE TRANSACTION RULES FOR ELECTRIC UTILITIES, Rule 1220-4-4-.55(e)(1).

Citations to *Tennessee Code Annotated* §65-4-101 and §65-4-111 as jurisdictional assertions beg the question of extension of the Authority's jurisdiction beyond the utilities it regulates. Merely asserting that the proposed rule is "...for the purposes of carrying out the provisions..." of the Code is no more justification for delving into the operations of non-utility affiliates than it is for delving into the operations of any company, affiliated or not, that provides goods and services to the utility.

The CAD also argues that changes in SEC jurisdiction dictated by the Telecommunications Act of 1996 are somehow a harbinger of regulatory changes to come in the electric utility industry. If the sections cited by the CAD are scrutinized, however, it is apparent that state commission control over ratemaking is reaffirmed. That reaffirmation does not, however, expand the jurisdiction of state commissions "under otherwise applicable law". If anything, the uncertainty of changes that may yet come as deregulation continues that is evidenced by these statutory changes argues against promulgation of rules at this point.

Furthermore, lest there be any doubt, no portion of whatever rule or guideline, if any are adopted, should be applicable to Kingsport Power until all of the rule or guideline is applicable. As proposed, many of the burdensome requirements could be imposed on Kingsport Power, even though the pricing transaction provisions are exempted because Federal law provides oversight and regulation.

II. THE CAD'S COMMENTS IGNORE THE BASIC ECONOMIC INEFFICIENCY OF THE ASYMMETRIC PRICING SYSTEM CONTAINED WITHIN THE PROPOSED RULES.

The CAD endorses the "higher of", "lower of" cost or market approach that is commonly referred to as "asymmetric pricing". Asymmetric pricing has no economic

justification and actually has the effect of harming ratepayers. The EEI's comments correctly point out that "[T]he proposed guidelines would reduce economic efficiency, discourage efficient resource use, unnecessarily raise the costs for regulated and unregulated affiliates and discourage regulated and unregulated product and service innovation."³

Asymmetric pricing has the undesirable effect of discouraging transactions between affiliated companies. While its purpose may seem noble, asymmetric pricing causes affiliates and regulated entities to look elsewhere for products and services, thereby depriving the marketplace of competition and economics of scale. Fewer competitors will yield less competition and therefore higher prices. The higher prices will yield increased costs to the utility and thereby increase the rates for customers of the regulated entity. The regulated entity and the consumer are deprived of economies of scale that could reduce costs to the regulated entity and thus reduce cost to the consumer. Asymmetric pricing has the effect of benefiting competitors of the affiliate at the expense of the regulated entity and consumers.

In the CAD's world, there can be no benefit to obtaining services from an affiliate. For example, the CAD asserts "To allow the utility to charge the rate payers more than the cost of allowing the utility to transfer a necessary function to an affiliate is inconsistent with generally accepted regulatory principles. For example, a utility could create an affiliate and transfer to that affiliate the employees and equipment used for billing and collection operations".⁴ The CAD would like the TRA to think there are only snakes under this regulatory rock which, if turned over, will allow the snakes to slither

³ INITIAL COMMENTS OF THE EDISON ELECTRIC INSTITUTE at page 9.

⁴ COMMENTS OF CONSUMER ADVOCATE DIVISION at page 9.

among and harm the rate payers. In reality, particularly with advanced technology and economies of scale, there are pearls. Instead of allowing the utility ". . . to artificially raise the cost. . ." on the CAD's assumption that "the costs. . . incurred by the affiliate would remain the same," the unit cost could be dramatically decreased by using more efficient computers, telecommunications enhancements, and full use of employees' time. The market rate for such services might very well be less than the cost previously incurred by the utility.

If AEP had employed the CAD's analysis, Kingsport Power would still render all of its bills locally instead of sharing that function with Appalachian Power, and would still have local employees handling the few emergency calls that come in instead of sharing that function with other sister companies in its call center. The CAD's analysis is flawed.

CAD's comments depict affiliate transactions as not "arms-length". As such, according to CAD:

"[T]he level of scrutiny required by a regulatory agency is greater than that required when the parties are nonrelated. Unlike transactions between unaffiliated parties, these (affiliate) transactions may not be market driven and may not reflect the best price for the service or product provided."⁵

Contrary to the CAD's unsupported assertions, asymmetric pricing assures that affiliate transactions will not be market driven and, even more importantly, denies to the ratepayers the benefits of market driven prices.

EEl correctly notes that asymmetric pricing not only distorts market results, but also discourages innovation. "[T]he guidelines would impair an affiliate's efforts to seek more efficient ways of providing products and services in competitive markets, including

ways of sharing resources efficiently. Just as rules that unfairly favor particular market participants distort efficient market outcomes (either regulated or unregulated market outcomes), rules that disfavor a particular market participant produce similar effects.”⁶

It remains the belief and position of Kingsport Power that neither rules nor guidelines are necessary regarding cost allocation and affiliate transactions. Should the Authority determine, however, that some direction is necessary, then broad principles, such as those espoused by EEI are preferable to rules because they provide the flexibility the Authority needs to deal with a multitude of circumstances.

As between the CAD and the EEI pricing proposals, EEI’s proposal more effectively balances the need for consumer protection against cross-subsidization with the consumer interest in a competition-rich market than does asymmetric pricing. Specifically, EEI proposes alternate pricing methods that provide the TRA with flexible alternatives to deliver benefits to consumers in a mixed regulated/competitive market environment. The rigidity of the asymmetric pricing system deprives the TRA of the flexibility to adapt to changing market and regulatory conditions, thus depriving the TRA of the ability to act in the best interests of consumers and regulated entities. Asymmetric pricing lacks economic justification, is unnecessarily rigid in its application, and has the effect of harming consumers and regulated entities while unfairly benefiting competitors of affiliates and therefore should not be implemented in any rules or guidelines which may be adopted.

III. CAD’S PROPOSED RULES REGARDING THE COST ALLOCATION MANUAL (“CAM”) AND AUDIT REQUIREMENTS ARE UNNECESSARY AND CONTRARY TO INDUSTRY STANDARD AND HAVE THE EFFECT OF INCREASING COSTS TO RATEPAYERS.

⁵ Id. at page 1.

⁶ INITIAL COMMENTS OF THE EDISON ELECTRIC INSTITUTE at page 3.

As suggested in Kingsport Power's initial comments, the CAM and Audit Requirements are not necessary in light of CAD's proposed principle (b)(3). To the extent possible, the transactions must be traceable in order for the Authority to monitor affiliate transactions. Under CAD's proposed principle (b)(3) all documentation requirements contained within the CAM and Audit Requirements sections are satisfied.

CAD notes in its comments that "an entity providing both regulated and unregulated service must have in place procedures to allocate or otherwise assign cost."⁷ The CAD goes on to state that "the proposed requirement should have little or no impact [on regulated entities]."⁸ The CAD comments ignore the fact that the proposed rule materially changes the basic accounting unit by which regulated entities report their transactions. The CAD proposal also asks the Authority to deviate from the industry standard for accounting by regulated entities. For example, the proposed rule inserts *each* "product or service" for "category or class" when allocating cost and in providing information for the CAM.

Industry standards currently adhered to provide the verification of costs needed to permit the Authority to carry out its duties. The current industry standard calls for accounting by "category or class" rather than by *each* "product or service". As explained by EEI, "the reporting of revenue by each service and product provided is not cost effective and could potentially require significant and costly modifications or additions to existing accounting systems."⁹ Such changes "would potentially increase costs of compliance that the Authority should permit the affected utility to recover in rates."¹⁰

⁷ COMMENTS OF CONSUMER ADVOCATE DIVISION at page 11.

⁸ Id.

⁹ INITIAL COMMENTS OF THE EDISON ELECTRIC INSTITUTE at page 6.

¹⁰ Id.

Any rules or guidelines adopted by the TRA should comport with industry standard and require accounting by “category or class” rather than *each* “product or service”.

Additionally, the proposed rules require regulated entities to report revenue by each “service or product” in the CAM. The CAM is not intended to be a financial report.¹¹ As such, Kingsport Power is in agreement with EEI that the TRA should strike the proposed guideline that the regulated entity include revenue reporting requirements in the CAM.

The proposed rules regarding Audit Requirements allow the TRA “complete access” to the books and records of the affiliates of a regulated utility in order to “ensure that cost allocations and affiliate transactions are conducted in accordance with [the proposed rules]”.¹² The EEI comments correctly point out that should the TRA choose to enact guidelines or rules, access “should be limited to relevant transactions that relate to the regulated business or ratemaking activities. Non-regulated affiliates should not be subject to burdensome and intrusive examination of portions of their business records when the transactions at issue do not pertain to the regulated business and ratemaking.”¹³ Access to records that relate to specific jurisdictional activities would guard against cross-subsidization without exposing the nonregulated affiliate to unduly burdensome and overbroad audit requests.

IV. THE PROPOSED RULES ARE BASED ON THE NARUC’S SUBCOMMITTEE ON ACCOUNTS’ DRAFT OF PROPOSED GUIDELINES THAT ARE NOT INTENDED TO BE RULES.

¹¹ Id. at page 7.

¹² PROPOSED COST ALLOCATION AND AFFILIATE TRANSACTION RULES FOR ELECTRIC UTILITIES, Rule 1220-4-4-.55(e)(1).

¹³ INITIAL COMMENTS OF THE EDISON ELECTRIC INSTITUTE at page 11.

CAD'S comments state that "[T]he proposed rules submitted to the Tennessee Regulatory Authority are based on the proposed guidelines adopted by the Staff Subcommittee on Accounts at its September 1998 meeting for submission to the NARUC."¹⁴ Kingsport Power's revised comments address the fact that the guidelines are under revision and are not final. In fact, the NARUC's latest version is drastically different than the version upon which the CAD is relying.

Undoubtedly, given that the process at NARUC is incomplete, significantly more changes are yet to come. Additionally, the preamble to the Guidelines for Cost Allocations and Affiliate Transactions submitted by the Staff Subcommittee on Accounts states "[T]hese Guidelines are not intended to be rules or regulations prescribing how cost allocations and affiliate transactions are to be handled. They are intended to provide a framework for regulated entities and regulatory authorities in the development of their own policies and procedures for cost allocation and affiliated transactions."¹⁵ In drafting the Guidelines, the NARUC Staff Subcommittee on Accounts recognized the inadvisability of a rigid framework of rules. The preamble goes on to state "[I]t is intended that there be latitude in the application of these guidelines, subject to regulatory oversight."¹⁶ It is obvious from the NARUC Staff Subcommittee on Accounts' draft that these Guidelines were never meant to be rules. CAD's proposal attempts to have TRA apply the Guidelines in a manner in which the Guidelines were never intended. Should TRA decide to act on CAD's Petition for Rulemaking, TRA should follow the NARUC Staff Subcommittee on Accounts intent and adopt guidelines for cost allocations and

¹⁴ COMMENTS OF CONSUMER ADVOCATE DIVISION at page 3.

¹⁵ NARUC STAFF SUBCOMMITTEE ON ACCOUNTS GUIDELINES FOR COST ALLOCATIONS AND AFFILIATE TRANSACTIONS at page 1.

¹⁶ Id.

affiliate transactions rather than rules. The rigid framework of a system of rules would deprive TRA of the ability to adapt to the uncertain landscape of a mixed regulated/competitive economic environment.

V. CONCLUSION

For the reasons cited in its preliminary comments, revised comments and reply comments, Kingsport Power respectfully requests that the TRA deny CAD's Petition for Rulemaking. In the alternative, if the TRA finds it advisable to begin to identify the salient parameters in this changing environment, Kingsport Power requests TRA adopt guidelines as set forth above for cost allocations and affiliate transactions rather than rules, with language adopted by order substantially as follows:

Proposed Cost Allocation and Affiliate Transaction Guidelines for Electric Utilities

COST ALLOCATION AND AFFILIATE TRANSACTIONS

(a). DEFINITIONS

1. Affiliates - companies that are related to each other due to common ownership or control.
2. Cost Allocators - the methods or ratios used to apportion costs. A cost allocator can be based on the origin of costs, as in the case of cost drivers; cost-causative linkage of an indirect nature; or one or more overall factors (also known as general allocators).
3. Combinations or Negotiated - combinations of other methods, which may include "the higher of" or "the lower of" several methodologies or other negotiated methods.
4. Common Costs - costs associated with services or products that are of joint benefit between regulated and non-regulated business units.
5. Cost Driver - a measurable event or quantity which influences the level of costs incurred and which can be directly traced to the origin of the costs themselves.

6. Direct Costs - costs which can be identified with a particular service or product.
7. Fully Allocated - services or products bear the sum of the direct costs plus a proportional share of indirect costs.
8. Incremental - new services or products support only the incremental costs added by their operations while one or more pre-existing services or products support the fixed costs.
9. Indirect Costs - costs that cannot be identified with a particular service or product. This includes but not limited to overhead costs, administrative and general, and taxes.
10. Market Driven - costs are allocated to services or products on a basis equivalent to the costs that would be incurred in the competitive market.
11. Non-regulated - refers to services or products that are not subject to regulation by the Authority.
12. Regulated – refers to services or products that are subject to regulation by the Authority.
13. Subsidization – when one business unit pays for costs that, in consideration of the facts and circumstances, pertain to another business unit.

(b). COST ALLOCATION PRINCIPLES

1. To the maximum extent practicable, in consideration of cost benefit standards, costs should be collected and classified on a direct basis for each category or class provided.
2. The general method for charging indirect costs should be on a fully allocated cost basis. Under appropriate circumstances, the Authority may consider incremental, market-driven, negotiated pricing or other methods for allocating costs and pricing transactions among affiliates.
3. To the extent possible, all direct and allocated costs between regulated and non-regulated products and services shall be traceable on the books of the applicable regulated utility to the applicable Uniform System of Accounts. Documentation, including a description of the cost allocators and methods used by the regulated entity and the cost allocators and methods used by its affiliates related to the regulated services and products provided to the regulated entity, shall be made available to the Authority upon request regarding transactions between the regulated utility and its affiliates.

4. Entities shall maintain all information underlying affiliate transactions with the affiliated utility for a minimum of three years, or as required by law or regulation if longer than three years.

(d). APPLICATION OF GUIDELINES

1. These guidelines shall apply to regulated entities providing both regulated and non-regulated products and services, except as otherwise required by law or regulation. (Specific examples of such law or regulations are the provisions of The Public Utility Holding Company Act of 1935 which requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies, and transactions under tariffs approved by the Federal Energy Regulatory Commission (FERC)).

Respectfully submitted,

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